CIA/OER EIWA 74/04/10 ITALY: MODERATE GROWTH

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Economic Intelligence Weekly

Italy: Moderate Growth, Financial Pains in 1974

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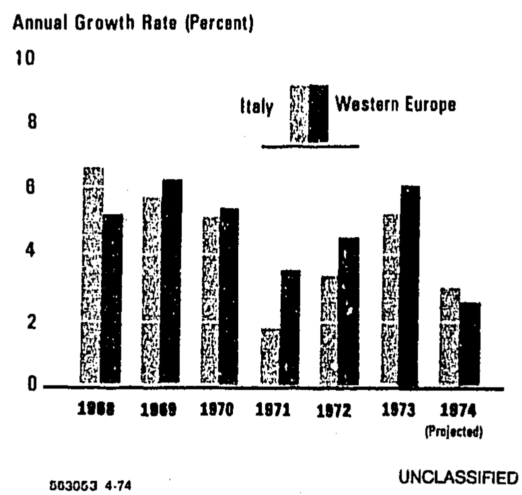
ITALY: MODERATE GROWTH, FINANCIAL PAINS IN 1974

1. For Italy, 1974 promises to be a year of moderate economic growth and immoderate increases in prices, unemployment, and the trade deficit. The government will continue to subordinate financial considerations to economic growth and to welfare needs -- better health benefits, public transportation, and schools. The anticipated 3% gain in real GNP, while below Italy's 1968-73 average of 4.5%, is slightly above the average forecast for West European countries.

2. Little constructive action to damp inflation and improve the payments balance can be expected from the present government, the 36th since World War II and the fifth headed by Mariano Rumor. The three coalition parties disagree over the advisability of curbing aggregate demand through fiscal measures. Once again, policy differences temporarily have been papered over by leaving the burden of deflation to monetary policy. The semi-autonomous monetary authorities are tightening the supply of short-term credit to damp inflation and reduce capital outflows. But this effort, too, is constrained by the national commitment to economic growth. The government is intent on keeping down long-term interest rates to encourage industrial investment, particularly in export industries.

ITALY: COMPARATIVE GROWTH OF REAL GNP



3. Excess demand thus is likely to continue, reinforcing the inflationary effects of sharply increased prices for imported fuels and raw materials. The rise in consumer prices already has reached an annual rate of about 20% and is likely to accelerate during the next several months unless world commodity prices ease. Barring reduced prices for imports of oil, beef, and other commodities or rationing of major import items, Italy is faced with a record trade deficit of about $11 billion in 1974. The massive borrowing abroad needed to finance the payments deficit is well under way.

Recent Developments

4. The pace of Italian economic activity accelerated following the settlement of major labor disputes last April. Fanned by strong consumer and investment demand plus orders from booming foreign markets, industrial production rose at about a 10% annual rate during the summer and fall. During the second and third quarters, unemployment fell from about 3.5% of the labor force to 3%, the lowest rate since 1964. Business confidence was buoyed by the slowing of inflation following the price freeze on major consumer items and restraints put on credit expansion in July. By September, the inflation rate had been almost halved, to an annual rate of 7%. The trade deficit dropped as exports surged, and the lira regained almost one-half the value lost after it was floated in February 1973.

5. Meanwhile, large wage increases won early in the year and rapid credit expansion were adding to the pressure on resources. Because of excess demand, soaring import costs for commodities, and traditional Italian finesse in evading regulations, the price freeze soon developed cracks. Inflation accelerated sharply to an annual rate of about 20% in the last months of the year. By early 1974, as Italy began to feel the effects of the increase in oil import costs and widespread hoarding of goods, spiraling prices threatened to bring another round of wage demands.

6. Despite mounting inflation, the coalition partners could agree only to continue relying on increasingly ineffective price controls and curbs on short-term credit to slow inflation. Sentiment remained strong for heavy government spending to support employment and improve social-welfare, aggravating an already massive budget deficit. Fearing increased unemployment among their blue-collar constituents, the coalition's Socialists blocked the austerity policy proposed by Treasury Minister Ugo La Malfa of the Republic Party. This action brought down the government early last month.

Prospects for 1974

7. The new Italian government is designed primarily to guide the country past the touchy divorce referendum scheduled for 12 May. It can scarcely be expected to take decisive steps against inflation. This government has the same incompatible economic aims as its predecessor: it wants to stimulate rapid economic growth and use fiscal policy to bring about major social reform, yet reduce inflation and hold down the trade deficit. In practice, this policy means precedence for economic expansion and employment. So long as the coalition includes the Socialists, government spending hardly will be trimmed or tax rates raised for most of the people. Even if the government were willing to moderate its spending, actual outlays probably would be affected little in the short run because of Italy's

unusually inefficient and obstructive bureaucracy. The monetary authorities thus will once again carry the burden of economic stabilization. Because of basic conflicts in its goals, however, monetary policy is unlikely to reduce aggregate demand or capital outflows appreciably.

8. With no major outbreak of labor strife, real GNP probably will rise by 3% rather than the 4.5% gain still being forecast in government circles. Sharply rising prices will erode consumers' purchasing power; rising costs plus heightened economic and political uncertainties will discourage investment. Growth of industrial production is likely to slow to about 4% owing to the sluggish economic pace at home and abroad. Although widespread dismissals will be avoided, some workers will have shorter hours, and few jobs will be available to new workers. The unemployment rate is expected to jump from the recent annual average of 3.5% to 4.5%. Under these conditions, union leaders will be hard put to control the rank-and-file and maintain Italy's fragile labor peace.

9. In 1974, Italy again will have one of Europe's highest inflation rates – probably about 25%. Prices are spiraling upward with increasing momentum, led by increased costs for oil, beef, and other major commodity imports and anticipatory buying of a wide range of goods. In addition, labor contracts recently negotiated in the automobile, rubber, and plastics industries indicate that labor costs in manufacturing will rise about 20% this year. A record budget deficit will add to the pressure. Under these circumstances, the government's flexible price controls on major consumer items will have little impact.

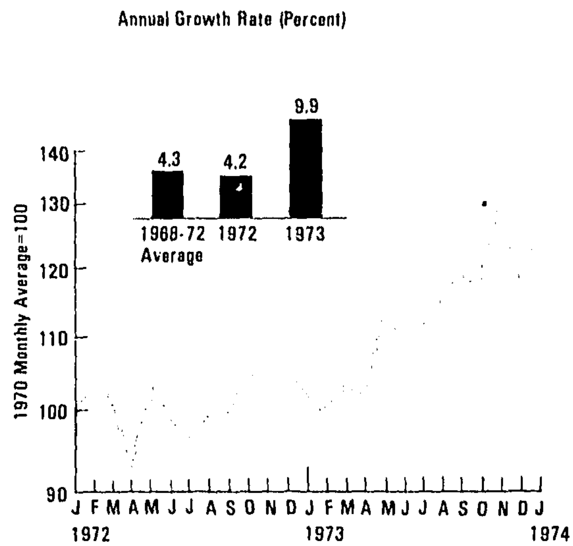
10. A higher rate of inflation in Italy than in most other industrialized countries is likely to further depress the international value of the lira, which already has dropped by more than 20% on a trade-weighted basis since 1971. Less buoyant demand in other industrial countries nonetheless will hold down Italian export growth, while increased prices will push up the import bill sharply. As a result, Italy faces a 1974 trade deficit estimated at $11 billion. Only if the government imposes additional restraints on domestic beef and oil consumption is the deficit likely to be as small as $9 billion. Net receipts from tourism and workers' remittances – although smaller this year because of slackening growth in the other developed countries – will offset part of the trade deficit, leaving the current account in the red by an estimated $8 billion.

11. Massive foreign borrowing will be required to finance this deficit and to offset a continued net outflow of capital. While Italy's credit standing may be weakening, Rome already has lined up much of the money needed this year. Italy has a standby credit of $1.2 billion with the IMF, and the Bank of Italy's standby credit line with the Federal Reserve Bank of

New York has been increased by $1 billion, to $3 billion. Medium-term borrowing by state organizations will likely prove to be Italy's largest source of funds in 1974. For example, the state credit institution, Mediobanca, already has negotiated a $1.2 billion loan from a syndicate of foreign banks, and the state oil company, ENI, has just obtained a $50 million multi-currency loan.

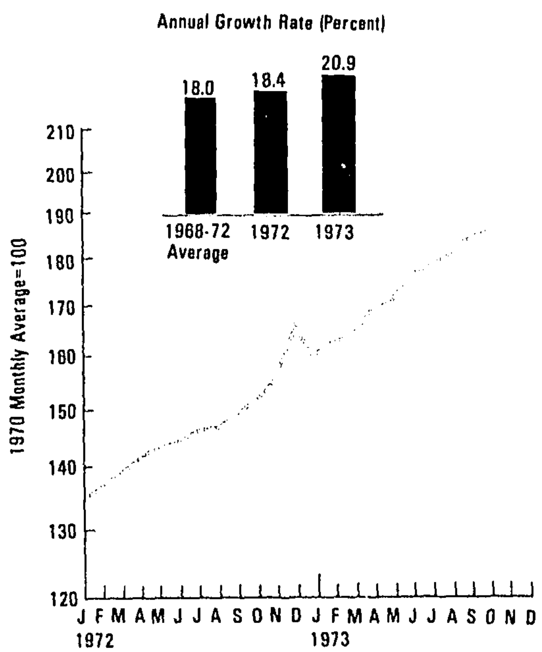
ITALY: INTERNAL ECONOMIC INDICATORS

INDUSTRIAL PRODUCTION*



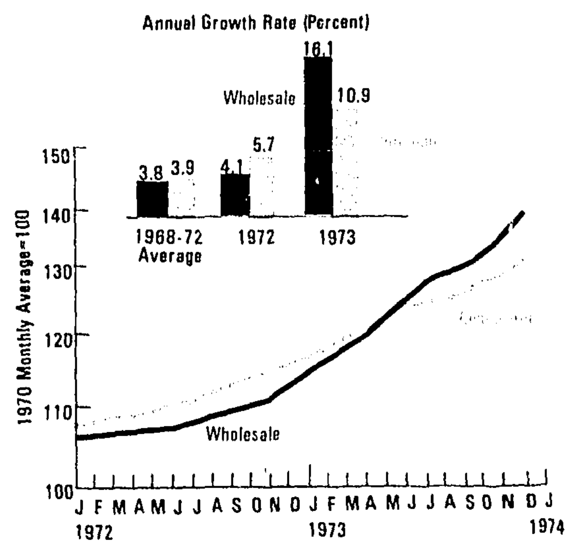
*Seasonally adjusted.

MONEY SUPPLY*



*Seasonally adjusted. End of period.

PRICES



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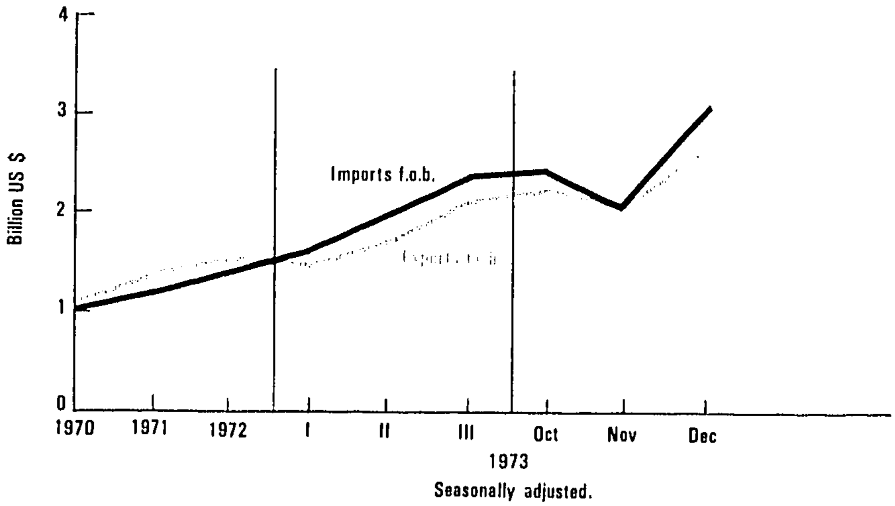
ITALY : EXTERNAL ECONOMIC INDICATORS

VALUE OF TRADE

Monthly Average



TRADE BALANCE

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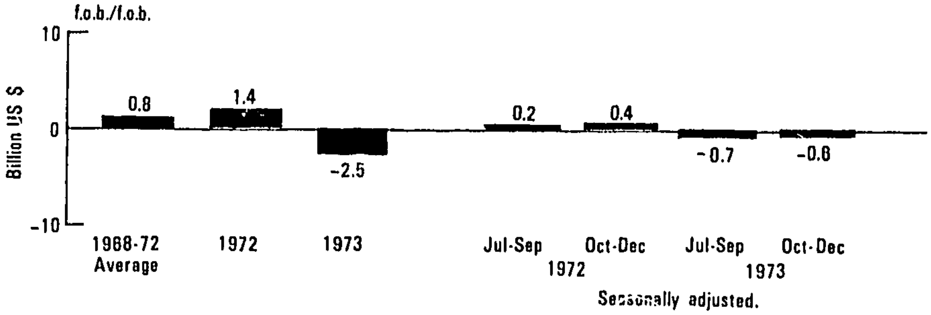
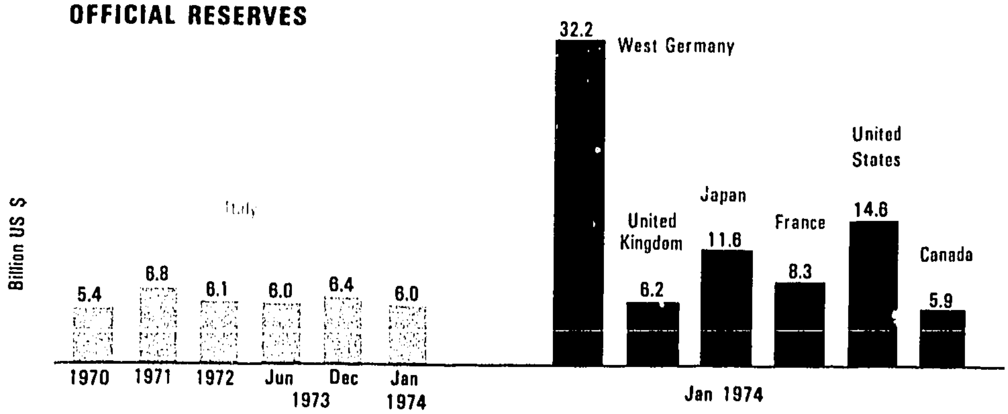


OFFICIAL RESERVES



Note: End of period.

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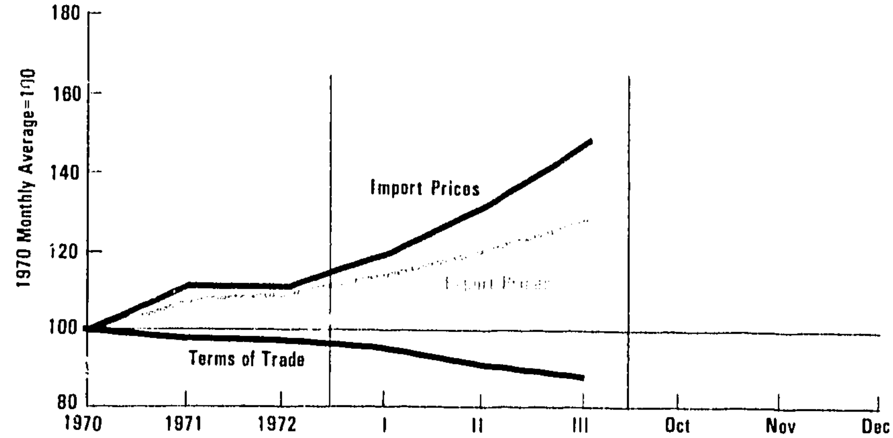
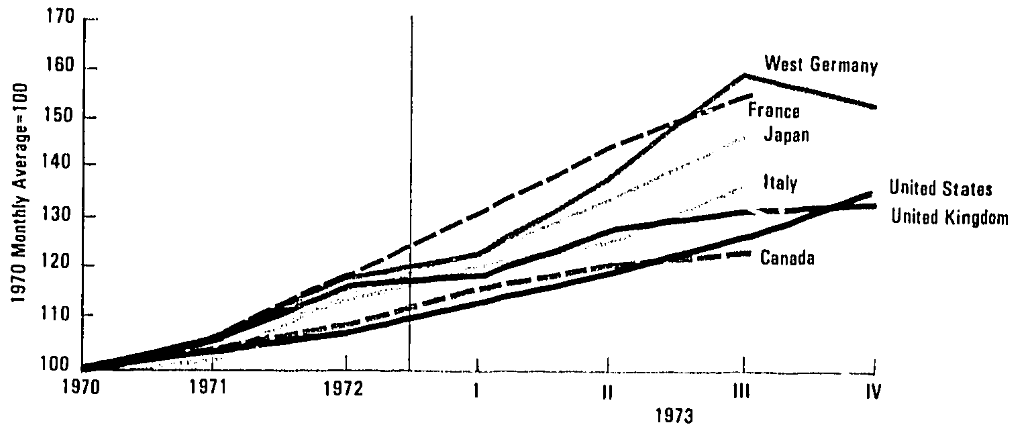
ITALY: EXTERNAL ECONOMIC INDICATORS

TERMS OF TRADE
National Currency

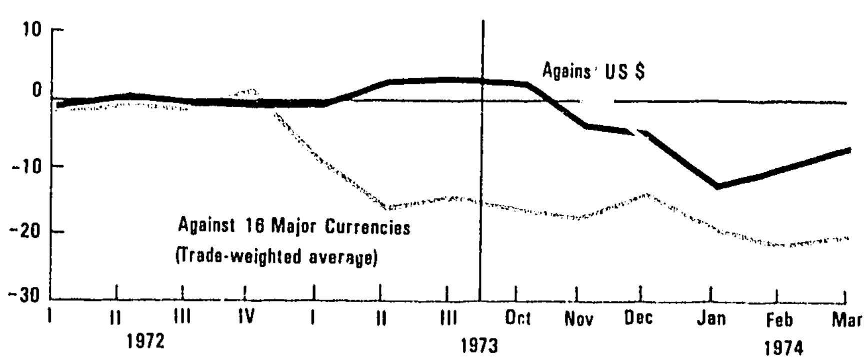


Note: Unit value indexes.

EXPORT PRICES IN US $



EXCHANGE RATES FOR THE ITALIAN LIRA
Percent Change from 18 Dec 71



Note: End of period.

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